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Outlook for the Economy and Real Estate

REALTOR®

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Outlook for the Economy and Real Estate

The economic outlook for 1986 and 1987 has improved considerably over the past month due to the decline in the price of imported oil, the decline in the value of the dollar relative to the currencies of our major trading partners, and further declines in long-term interest rates. As a result, our forecast for real or inflation-adjusted Gross National Product (GNP) for 1986 has been revised up from 2.2 percent to 3.0 percent and for 1987 from 1.5 percent to 2.8 percent. However, while these developments have given the economy a needed boost, the underlying trend of a gradually weakening recovery remains in place. The threat of recession in late 1986 or 1987 appears to have been pushed back to 1988.

One year ago the spot price of oil in international markets was over $28 per barrel while currently it is below $15 per barrel due to a breakdown in OPEC's system of production quotas. This decline in the price of imported oil boosts the prospects for economic growth in several ways:

1) As the prices of gasoline, heating oil, and other petroleum-derived products decline, consumers spend less of their income on these products, leaving more of their income for purchases of other goods and services and saving. This boost to consumer spending power comes just when growth in consumption spending was waning in response to historically high consumer debt burdens.

2) Given the pervasive use of petroleum-derived products in our economy, the reduction in oil prices reduces the forecast for inflation. With reduced inflation expectations, long-term interest rates should decline (as they have), providing stimulus to residential and business investment.

3) In addition to lowering interest rates and boosting the value of bond portfolios, lower oil prices improve the profitability of oil-consuming businesses, boosting their stock prices (as has indeed happened). The increase in stock and bond prices increases household net worth and stimulates additional consumer spending.

The unexpectedly sharp decline in the dollar since last September, when the five major industrial nations announced an agreement to reduce the value of the dollar, also improves the outlook for the economy although its impact will build gradually. Already the decline in the dollar relative to currencies such as the Japanese yen has increased the cost of such products as imported automobiles and electronic equipment, discouraging their purchase by American consumers. At the same time domestically produced goods and services are more competitively priced, boosting U.S. exports. However, foreign trade currently taking place was negotiated months ago and so it will take some time for international trade flows to reflect the change in currency values. But, from this point forward the U.S. trade deficit should start to fall, boosting the domestic growth rate.

While lower oil prices and the lower value of the dollar jointly act to stimulate economic growth, they have opposite effects on inflation. Lower oil prices tend to reduce inflation, however, the reduced value of the dollar causes the prices of imported goods and services to rise and reduces downward price pressure on domestically-produced goods and services. The timing of the effects is also likely to be different, with the downward pressure from falling

oil prices concentrated in 1986 while the upward pressure from the lower dollar building over time and having its greatest impact in 1987 and 1988. The forecast for inflation for 1986 (as measured by the Consumer Price Index) has been revised downward from 3.3 percent to 2.8 percent. In 1987 and 1988 inflation should then accelerate to the 3-1/2 to 4 percent range.

Even though the civilian unemployment rate rose in February to 7.3 percent from 6.7 percent in January, payroll employment continued to increase at the healthy pace of 226,000 jobs. The unemployment rate is likely to be erratic over the next few months due to changes in the way that statistic is computed and seasonally adjusted. Regardless, the improved outlook for economic growth should result in the creation of about 1.7 million jobs this year with the unemployment rate falling to the low-6 percent range toward the end of the year.

Over the past month the bond rally has continued with long-term interest rates falling another full percentage point. To add further fuel to the fire, on Thursday, March 6 the central banks of West Germany, France, and the Netherlands announced reductions in their discount rates followed the next day by similar action by Japan and a cut in the FED's discount rate from 7-1/2 percent to 7 percent. This coordinated easing of monetary policy is designed to stimulate economic growth in the major industrial economies through lower interest rates rather than deficit spending by the central governments. However, since U.S. interest rates will not decline by more than interest rates in Western Europe and Japan, this action should not prompt much additional decline in the value of the dollar. In his testimony before Congress, Chairman Volcker expressed concern about the dollar falling too much and the domestic inflationary pressures that would cause.

This further easing by the FED should allow short-term interest rates, which have been essentially flat for about six months, to trend downward about one-half percentage point over the remainder of 1986 and remain at that level through much of 1987. Long-term rates should also continue to trend downward over this period although the steep declines appear to be behind us. Long-term rates are likely to decline another one-half percentage point by the end of 1986 with additional declines in 1987 as overall economic growth slows.

Real Estate Markets

With mortgage rates down to the 10 percent level housing affordability has returned to the levels of late 1978. Builders have responded favorably, starting new housing units at a seasonally-adjusted annual rate of 2.09 million units in January, up 16 percent over December. Single-family starts were up 24 percent to a 1.35 million unit annual rate while multi-family starts were up just 2.5 percent to 735,000 units. Apparently, the threat of tax reform continues to dampen multifamily housing construction despite the significant decline in financing costs. Resales of single-family homes fell 5 percent in January to an annual rate of 3.32 million units following a 3.5 million unit pace during the last three months of 1985.

For all of 1986 a total of about 1.88 million new housing units should be started, up about 5 percent from 1985, while about 3.6 million existing single-family homes should be sold, up about 13 percent over 1985. The increase in demand should also cause home prices to rise at faster rates than during the previous three years. While overall inflation dips below 3 percent in 1986 the median sales price of existing single-family homes should rise about 5 percent compared to increases of 3-1/2 to 4 percent in 1984 and 1985.

March 1986

Table 1

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1984	1985	1986	1987	1988
AGGREGATE ECONOMY													
Gross National Product													
(billions of dollars)	4016.9	4061.5	4127.9	4190.3	4260.7	4332.1	4392.9	4444.6	3774.7	3989.1	4227.8	4474.3	4735.4
% Change	5.8	4.5	6.7	6.2	6.9	6.9	5.7	4.8	11.0	5.7	6.0	5.8	5.8
% Change (w/out inflation)	3.0	1.2	3.1	3.9	4.3	4.0	2.5	1.5	6.6	2.3	3.0	2.8	1.9
Consumption	4.6	0.1	3.1	3.1	5.1	2.4	1.0	0.8	4.4	3.5	2.9	1.8	1.7
Durables	24.3	-14.5	7.4	2.2	7.2	2.8	-1.4	-1.9	12.4	8.3	3.4	0.8	2.0
Nondurables	1.5	0.8	2.3	3.3	4.7	2.3	1.4	1.3	3.4	2.3	2.4	2.0	1.6
Services	1.4	4.8	2.3	3.3	4.7	2.3	1.4	1.3	3.0	2.5	3.1	2.0	1.6
Residential Investment	8.5	6.4	13.2	12.1	4.9	1.7	-2.2	-3.4	13.2	1.8	8.9	0.1	-0.5
Nonresidential Investmen	2.4	10.0	5.9	5.6	3.4	7.4	3.9	1.8	19.5	9.6	7.1	4.7	3.3
Structures	1.2	9.2	1.0	1.7	2.4	4.5	3.4	3.1	14.7	11.6	3.3	3.7	4.6
Equipment	3.0	10.4	8.6	7.7	13.2	8.8	4.1	1.1	22.2	8.6	9.1	5.3	2.6
Exports	-5.1	7.4	3.5	5.9	6.7	8.0	8.8	8.5	6.2	-2.9	3.2	8.2	4.9
Imports	12.8	18.6	4.8	3.5	2.6	2.3	0.6	-1.5	22.8	2.4	8.2	0.3	0.9
Government Purchases	18.2	8.5	-6.5	-7.3	-2.2	-0.1	0.1	-0.1	4.3	5.9	0.5	0.8	0.3
Contribution to GNP Growth													
Consumption	3.0	0.1	2.0	2.0	3.3	1.5	0.6	0.5	2.2	1.9	2.2	0.6	1.3
Residential Investment	0.4	0.3	0.6	0.6	0.2	0.1	-0.1	-0.2	0.2	0.3	0.4	-0.1	0.0
Nonresidential Investment	0.3	1.3	0.8	0.7	1.2	1.0	0.5	0.2	1.9	0.8	1.0	0.4	0.4
Structures	0.1	0.4	0.0	0.1	0.1	0.2	0.2	0.1	0.6	0.4	0.1	0.2	0.2
Equipment	0.3	0.9	0.7	0.7	1.1	0.8	0.4	0.1	1.3	0.4	0.8	0.2	0.2
Inventory Change ($ billions)	-1.9	-0.5	1.3	2.0	-0.4	0.9	0.6	-0.2	0.4	-1.2	1.0	0.0	0.0
Net Exports	-2.1	-1.6	-0.3	0.1	0.3	0.5	0.8	1.1	-1.5	-1.0	0.2	1.1	-0.1
Government Purchases	3.4	1.7	-1.4	-1.5	-0.4	0.0	0.0	0.0	1.5	1.4	-0.8	0.0	0.1
Mfg. Capacity Utilization Rate	80.3	79.9	80.1	80.4	80.9	81.2	81.0	80.4	80.8	80.3	80.6	80.3	79.4
Personal Income Per Household	40,040	40,613	41,082	41,504	41,969	42,435	42,952	43,364	38,175	40,029	41,740	43,561	45,550
% Change -- Year Ago	3.7	3.8	3.9	4.0	4.8	4.5	4.5	4.5	5.4	4.8	4.3	4.3	4.6
Personal Taxes Per Household	6,049	6,157	6,155	6,246	6,346	6,444	6,456	6,543	5,420	5,988	6,297	6,586	7,059
% Change	3.1	1.8	-0.0	1.5	1.6	1.5	0.2	1.3	-17.2	10.5	5.2	4.6	7.2
% of Personal Income	15.1	15.2	15.0	15.0	15.1	15.2	15.0	15.1	14.2	15.0	15.1	15.1	15.5
Disposable Personal Income Per Household	33,992	34,456	34,927	35,258	35,623	35,990	36,496	36,821	32,755	34,040	35,443	36,975	38,491
% Change -- Year Ago	3.5	3.6	4.5	2.8	4.8	4.4	4.5	4.4	5.7	3.9	4.1	4.3	4.1
Employment (millions)	115.5	116.2	116.5	117.0	117.4	117.8	118.2	118.6	113.5	115.5	117.2	118.8	120.0
(civilian:household basis)													
% Change	1.1	2.4	1.4	1.4	1.5	1.4	1.4	1.3	1.8	1.7	1.5	1.4	1.0
Unemployment Rate (%) (civilian)	7.2	7.0	6.7	6.6	6.4	6.2	6.1	6.3	7.5	7.2	6.5	6.3	6.0
Consumer Prices (CPI)	2.3	4.1	2.1	2.3	2.7	3.5	3.9	3.9	4.3	3.5	2.8	3.6	4.1
GNP Deflator	2.9	3.3	3.5	2.2	2.5	2.7	3.1	3.3	4.1	3.3	2.9	3.0	3.8
Personal Cons. Inflation	-2.2	4.0	2.3	2.4	2.6	3.4	3.8	3.8	4.1	3.2	2.8	3.5	3.9
Residential Construction	1.1	4.9	3.5	2.6	2.9	3.4	3.9	3.9	4.2	1.8	3.0	3.7	4.2
Nonresidential Const. Inflation	1.2	0.8	4.4	2.4	2.7	2.9	3.5	3.6	0.5	1.4	2.4	2.3	3.5
Producer Price Inflation	-0.8	4.7	-0.1	1.6	2.5	4.1	4.5	4.5	2.1	0.9	1.7	4.0	4.3
Before Tax Corporate Profit	228.6	235.5	229.9	236.1	246.0	258.6	256.9	253.4	237.6	225.7	241.9	255.4	240.9
Corporate Tax Liability	87.5	90.0	86.3	90.4	94.5	100.0	98.9	97.1	93.6	85.8	92.8	97.9	90.0
After Tax Profits	141.1	145.5	140.6	145.7	151.5	158.6	158.0	156.3	144.0	139.9	149.1	157.5	150.9
Inventory Valuation Adjustment	4.7	-10.0	-3.1	-8.8	-11.0	-16.7	-18.6	-19.3	-5.4	-0.6	-9.9	-20.0	-18.3
Capital Consumption Allowance	75.9	83.0	87.6	93.4	99.0	104.6	109.9	115.1	41.0	71.8	96.2	117.7	137.0
Federal Tax Receipts (NIA)	790.7	805.9	814.4	827.6	842.0	857.8	866.3	874.1	725.1	785.3	835.5	879.4	921.2
% of GNP	19.7	19.8	19.7	19.8	19.8	19.8	19.7	19.7	19.2	19.7	19.8	19.7	19.5
Federal Expenditures (NIA)	992.0	1028.4	1022.5	1011.5	1013.0	1018.3	1034.7	1042.9	898.0	984.2	1016.3	1046.5	1085.2
% of GNP	24.7	25.3	24.8	24.1	23.8	23.5	23.6	23.5	23.8	24.7	24.0	23.4	22.9
Deficit (NIA)	-201.3	-222.5	-208.1	-183.8	-171.0	-160.5	-168.4	-168.7	-172.9	-198.9	-180.9	-167.0	-164.1
% of GNP	5.0	5.5	5.0	4.4	4.0	3.7	3.8	3.8	4.6	5.0	4.3	3.7	3.5
% of Net Domestic Savings	67.7	72.4	65.1	57.3	52.4	18.2	48.9	49.0	51.1	63.0	55.6	48.4	47.3

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

TABLE 2

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REAL ESTATE AND FINANCIAL MARKETS

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1984	1985	1986	1987	1988
REAL ESTATE MARKETS													
Total Single-Family Home Sales (single-family resales and completions)	4.377	4.535	4.665	4.714	4.760	4.769	4.800	4.804	3.933	4.254	4.727	4.861	4.790
Percent Change -- Year Ago	17.2	18.5	16.0	15.5	8.8	5.1	2.9	1.9	5.1	8.2	11.1	2.8	-1.4
Existing Single-Family Sales (1000's)	3.360	3.500	3.529	3.595	3.666	3.702	3.742	3.755	2.866	3.215	3.623	3.798	3.705
Percent Change -- Year Ago	21.6	24.4	19.4	18.1	9.1	5.8	6.0	4.4	5.7	12.2	12.7	4.8	-2.4
Dollar Volume (billions)	310.5	318.0	327.9	341.2	355.4	350.1	368.4	384.9	247.1	290.9	343.6	382	393
Existing Home Prices - Median ($1000's)	76.6	75	77.3	78.8	80.4	78.6	81.5	83.1	72.9	75.1	78.8	83.1	87.2
Percent Change Year - Ago	4.6	4.2	4.7	4.8	4.9	4.8	5.4	5.5	3.6	3.9	4.9	5.5	4.9
Monthly Mortgage Payment (P&I, 80%, 30 yr)	614.4	562.7	531.6	520.2	525	500.8	516.1	513.4	665.1	611.9	519.5	502.5	497.1
Percent of Median Family Income	24	21	20	19	19	18	18	18	27	24	19	18	17
Housing Starts	1.688	1.747	1.897	1.905	1.874	1.829	1.805	1.786	1.763	1.735	1.876	1.803	1.799
% Change	-3.0	3.5	8.5	0.4	-1.6	-2.4	-5.1	-4.1	3.4	-1.6	8.2	-3.9	-0.2
Single-Family Units	1.048	1.070	1.171	1.154	1.128	1.100	1.091	1.082	1.100	1.072	1.136	1.096	1.119
Percent Change	-1.9	2.1	9.4	-1.4	-2.2	-2.4	-0.8	-0.8	3.3	-2.6	6.2	-3.7	2.1
Multi-Family Units	639	677	726	751	746	730	715	704	663	663	738	706	680
2-4 Family Units	89	81	86	90	89	87	85	84	122	93	88	84	81
% Change	-12.0	-9.1	6.2	4.8	-1.1	-2.2	-2.3	-1.2	7.9	-23.7	-5.4	-4.3	-3.7
5+ Family Units	550	596	639	662	657	643	630	621	542	570	650	622	599
% Change	3.8	8.3	7.2	3.6	-0.7	-2.1	-2.0	-1.4	2.8	5.2	14.0	-4.3	-3.7
Mobile Homes Shipped	285	290	303	301	298	295	295	294	295	283	299	298	300
New Single-Family Home Sales (1000's)	711	692	717	727	756	757	737	750	636	687	739	756	751
Percent Change -- Year Ago	15.0	11.0	7.2	10.6	6.3	9.4	2.3	3.2	6.1	8.0	7.5	2.2	-0.6
New Home Prices - Median ($1000's)	82.8	85.5	87.6	89.0	90.1	91.2	92.3	93.5	80.0	83.8	89.5	94.2	100.2
Percent Change -- Year Ago	1.8	6.5	5.7	6.0	6.8	6.7	5.4	5.1	6.1	4.8	6.8	5.2	6.4
New Home Prices--Mean (Quality Adjusted)	104.3	106.4	102.1	105.3	106.2	109.6	105.2	108.8	98.8	104	105.8	109.6	114.1
Percent Change -- Year Ago	7.3	7.5	1.0	3.1	2.3	3.0	3.0	3.5	6.6	7.4	1.7	3.6	4.1
NAR Affordability Index	90.5	99.3	104.8	108.2	108.2	114.6	112.8	114.3	89.1	95.5	109.0	117.5	124.0
Mortgage Debt Outstanding ($ billions)	2,224	2,386	2,331	2,392	2,455	2,421	2,587	2,653	1,943	2,202	2,400	2,687	2,954
Housing Inventory (millions)	95.4	95.8	96.3	92.6	93.3	93.7	94.2	94.6	93.4	95.2	94.0	94.8	96.6
Rental Vacancy Rate(%)	6.8	6.7	6.7	6.8	6.8	6.7	6.7	6.8	5.8	6.5	6.8	6.7	6.7
Office Vacancy Rate (%) <1>	16.2	16.5	16.6	16.8	16.8	16.9	17.0	16.8	13.9	16.0	16.8	16.8	16.4
Industrial Vacancy Rate (%) <1>	4.8	4.9	4.9	4.8	4.6	4.5	4.3	4.3	4.7	4.7	4.7	4.3	4.0
New Commercial Building Const. (% Ch Value)	59.8	61.6	10.7	1.9	7.9	-11.2	-11.3	-17.6	47.8	60.0	2.3	-10.5	1.3
New Industrial Building Const. (% Ch Value)	15.4	16.3	-6.4	5.0	7.2	2.5	5.3	3.9	13.7	15.8	2.1	4.9	9.2
FINANCIAL MARKETS													
Money Supply (M1)(% change)	15.7	11.0	7.7	6.8	7.1	6.8	5.8	5.1	6.9	9.1	9.1	6.2	5.5
Velocity of M1 (% change)	-8.6	-5.8	-0.9	-1.5	-1.1	-1.1	-0.1	0.2	3.8	-3.1	-3.3	-0.5	0.4
Value of the U.S. Dollar (Trade-Weighted)	1.39	1.28	1.20	1.17	1.15	1.15	1.14	1.12	1.38	1.43	1.17	1.12	1.17
Percent Change	-23.9	-28.1	-23.2	-9.6	-4.0	-4.0	-4.0	-4.0	10.4	3.5	-18.4	-4.6	4.9
Flow of Funds (NIA Basis) (Billions of dollars,saar)													
Sources:(total:gross savings)													
Private Saving	682	698	721	726	737	747	768	779	693	695	733	785	821
Personal Saving	103	118	125	123	120	121	130	130	173	129	122	128	113
Savings Rate	3.7	4.1	4.3	4.2	4.1	4.0	4.3	4.2	6.5	4.8	4.2	4.1	3.5
Gross Business Savings	579	582	596	603	616	626	638	649	521	566	610	658	707
Federal Deficit	-201	-223	-208	-187	-177	-171	-178	-177	-173	-199	-196	-174	-170
State & Local	57	58	56	55	56	56	57	56	64	59	58	56	64
Net Foreign Investment	-126	-145	-146	-140	-142	-141	-141	-139	-91	-114	-142	-137	-133
Uses (total:gross investment)	666	678	709	736	757	773	785	794	674	669	744	800	851
Nonresidential Investment	474	485	492	497	507	514	518	521	430	472	503	524	542
Structures	166	170	170	170	171	172	173	175	149	166	171	176	185
Equipment	308	316	322	327	336	342	345	346	282	306	332	348	358
Residential Investment	173	176	181	186	187	188	184	183	168	171	185	184	185
Inventory Investment	-1.8	-6.7	5.2	16.7	21.2	25.9	28.6	29.7	62.7	5.8	17.2	28.5	29.0
Selected Interest Rates (%)													
Mortgage Rates													
30-year Fixed Rate Mortgage	12.1	11.3	10.3	9.9	9.8	9.6	9.5	9.3	13.9	12.2	9.9	9.1	8.6
Real Mortgage Rate	9.2	8.0	6.8	7.7	7.5	7.0	6.5	6.2	9.7	8.9	7.0	6.3	4.9
1-year ARM (without buydown)	9.7	9.5	9.3	9.2	9.2	9.1	9.0	8.7	12.6	10.1	9.2	8.8	8.8
Real Mortgage Rate	8.8	8.2	8.8	7.0	6.9	6.5	6.0	5.6	8.5	6.8	6.3	6.0	5.1
Corporate AAA Bond Rate	11.0	10.6	9.8	9.5	9.4	9.2	8.9	8.7	12.7	11.4	9.5	8.5	7.9
Government Bond Rate	10.7	10.2	9.2	9.0	8.8	8.7	8.5	8.2	12.5	11.0	8.9	8.0	7.4
Real Government Bond Rate	7.8	6.9	5.7	6.8	6.5	6.1	5.5	5.1	8.4	7.7	6.0	5.2	3.7
Federal Funds Rate	7.9	8.1	7.8	7.6	7.3	7.2	7.3	7.0	10.2	8.1	7.5	6.7	6.7
3-Month T-Bill Rate	7.1	7.2	7.1	6.8	6.5	6.5	6.6	6.5	9.5	7.5	6.7	6.2	6.3
Real 3-Month T-Bill Rate	4.2	3.9	3.6	4.6	4.2	3.9	3.6	3.4	5.4	4.2	3.8	3.4	2.6
1 Year Treasury Bill Rate	8.0	7.8	7.6	7.5	7.5	7.4	7.3	7.0	10.9	8.4	7.5	7.1	7.1
Real 1 Year T-Bill Rate	5.1	4.5	4.1	5.3	5.2	4.8	4.3	3.9	6.9	5.1	4.6	4.3	3.4
Prime Rate	9.5	9.5	9.5	9.4	9.1	8.8	8.9	8.7	12.0	9.9	9.2	8.4	8.2
Discount Rate	7.5	7.5	7.4	7.5	7.1	7.0	6.6	6.6	8.8	7.7	7.2	6.4	6.3

<1> Historical Data courtesy of Coldwell Banker.
<2> FHA secondary mortgage market rate.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

Economic Impacts of The Gramm-Rudman-Hollings Deficit Reduction Legislation

On December 11, Congress passed and the President signed the Balanced Budget and Emergency Deficit Control Act of 1985, otherwise known as the Gramm-Rudman-Hollings (GRH) proposal. This legislation, sponsored by Senators Gramm (R., Texas), Rudman (R., New Hampshire) and Hollings (D., South Carolina), establishes a path of shrinking deficits starting in FY1986. The mandated deficit targets are as follows: $172 billion in FY1986, $144 billion in FY1987, $108 billion in FY1988, $72 billion in FY1989, $36 billion in FY1990, and a balanced budget in 1991. The Administration is constrained by these deficit limits in formulating the annual budget that is submitted to the Congress. Similarly, Congressional budget resolutions are required to adhere to these targets.

On March 1, 1986 and then on each following September 1, the Congressional Budget Office (CBO) and the Administration's Office of Management and Budget (OMB) are required to prepare estimates of the deficit for the remainder of FY1986 or the following fiscal year, taking into account expected economic conditions and Congressional budget actions as of that date. These estimates are to be submitted to the Comptroller General of the General Accounting Office (GAO) who is to review the estimates and resolve differences. If GAO determines that the projected deficit exceeds the target for the fiscal year by more than $10 billion, the President would be required to make automatic spending reductions to achieve that target if Congress and the President are unable to agree on an alternative plan by October 15. Defense would take half of the automatic spending cuts while domestic programs would take the other half, with Social Security, interest on the debt, and the primary low-income programs exempt. Note that while the automatic feature of the bill calls for spending reductions only, taxes could be increased as part of an alternative plan to achieve the deficit target.

Also included in the bill is a provision for waiving this procedure in the event of a weak economy. If CBO or OMB project two consecutive quarters of negative growth in real or inflation-adjusted Gross National Product (GNP) or if the Department of Commerce reports that real GNP growth during the current quarter and the immediately preceeding quarter is less than 1 percent, the deficit target is waived for the remainder of the current fiscal year and/or the following fiscal year.

Provided the Federal Reserve Board (FED) acts quickly to offset the decline in aggregate demand resulting from the cuts in federal spending with lower interest rates brought on by a more accommodative monetary policy, deficit reduction through spending cuts would have very desirable impacts on overall economic performance. As shown in Table 1, as the federal governments borrowing requirements decline savings now being absorbed by the deficit would be available to the private sector, thus allowing interest rates to decline. Lower interest rates would have numerous beneficial impacts--increased activity in the interest-sensitive sectors of the economy such as housing and business investment, a reduced value of the dollar which would allow a steady decline in the U.S. trade deficit, and further reductions of the federal deficit by reducing interest payments on the outstanding federal debt. By the end of the decade housing starts would be up by about 260,000 units or 14 percent. Nonresidential fixed investment would increase by about 10 percent. Within five years total employment would increase by over a million jobs while real GNP would be up by about 1-1/2 percent. The only negative effect would be an increase of inflation of about one percentage point. This would be due primarily to the reduced value of the dollar which would boost the cost of imported goods and services and diminish price pressure on domestic producers. However, this increase in inflation would subside as the dollar stabilized at its new lower value. Without an accommodative shift in monetary policy, the reduction in federal

spending prescribed by GRH would cause weakness in the economy. However, that fact plus continued low inflation would likely induce the FED to provide the needed stimulus.

Table 1

Macroeconomic Impacts of the Gramm-Rudman-Hollings Proposal with Accommodative Monetary Policy[1/]
(percent change from baseline)

	1986	1987	1988	1989	1990	1991
Real GNP	0.1	0.7	1.0	1.2	1.2	1.5
Inflation (Percentage Points)	0.0	0.2	0.5	0.7	0.8	0.9
Employment (Millions of Jobs)	0.0	0.2	0.4	0.6	0.7	1.1
Mortgage Rate (Percentage Points)	-0.6	-1.3	-1.7	-1.8	-1.9	-2.0
Housing Starts (Thousand of Units)	84.7	199.6	259.1	261.9	219.3	148.9
% Change	4.4	10.1	13.7	14.1	11.7	7.9
Single Family	51.5	113.3	138.0	126.9	91.7	46.2
% Change	4.4	9.2	11.5	10.6	7.6	3.8
Multi-Family	32.7	86.3	121.1	135.0	127.6	102.7
% Change	4.4	11.6	17.6	20.5	19.4	15.7
Nonresidential Investment						
Equipment	0.5	2.7	5.4	7.8	9.3	9.7
Structures	0.3	1.9	4.3	6.9	9.4	11.7

Source: NATIONAL ASSOCIATION OF REALTORS®

1/Note: For this simulation deficit reduction is achieved through slower federal spending growth only with half the reduction from defense and half from the nondefense programs not exempt from GRH cuts.

Unfortunately, this desirable scenario is unlikely to come about due to the inability to reach a political consensus on the required reductions in spending growth. The President will likely resist deep cuts in defense spending while House Democrats will likely resist deep cuts in social programs. This leaves two options--either tax increases or GRH will be subverted or repealed through future legislation. At this point it seems reasonable to expect that some deficit reduction will occur in roughly the following proportions-1/3 from defense, 1/3 from nondefense programs, and 1/3 from increased taxes. Given the current sentiment in Washington the increase in tax revenues is most likely to be gained by imposing higher taxes on business investment such as lengthening of depreciation schedules and reducing or eliminating the investment tax credit rather than by an across-the-board increase in personal tax rates. However, as the following

economic simulations reveal, if a tax increase is to occur an increase in personal taxes would be the least damaging to the economy over the long-run.

Table 2 shows the economic impacts of deficit reduction through a combination of an increase in business taxes and slower growth of federal spending. Business taxes are raised by halving the investment tax credit (ITC) for both equipment and structures and lengthening the recovery periods for equipment from an average of 4.6 to 9.2 years and for structures from 19 to 30 years. Despite an easier monetary policy real GNP growth declines substantially by the end of the decade. Mortgage rates decline about 1-1/2 percentage points due to reduced government borrowing and the slower growth of the economy, however, the resulting increase in housing starts is about 60 percent of the increase in the no tax increase case since interest rates have declined less and because employment and household income are lower. Nonresidential investment declines severely throughout the period, with spending for structures down over 6 percent and spending for equipment dropping more than 15 percent as a direct result of the loss in value of depreciation deductions and the investment tax credit. The level of real GNP is about 3 percent lower by 1991 with about 500,000 fewer jobs.

The decline in mortgage interest rates is less than in the no tax increase case because reducing depreciation deductions and investment tax credits to increase tax receipts has the simultaneous effect of reducing business savings. Thus, while the deficit is declining total domestic savings is also declining substantially. In this scenario, spending by the federal government permanently crowds out private investment. The slower growth of capital formation results in slower growth potential of the economy, resulting in fewer jobs and lower real incomes.

Table 3 presents the economic impacts of deficit reduction through an increase in personal taxes combined with slower growth of federal spending. Personal tax revenues are increased through a 10 percent increase in federal tax rates each years from 1986 through 1991. Note that while the overall impact on real GNP and employment is still negative, the impact is considerably less severe than with an increase in business taxes. By 1991 real GNP is below the baseline by about 1 percent while employment is down by about 300,000 jobs due to a contraction in consumption spending. Investment in equipment is up about 5-1/2 percent while investment in nonresidential structures is up nearly 7 percent. Over the total six year period housing starts have increased significantly more than in the business tax increase case while they are about 30 percent below the no tax increase case.

The favorable impact on residential and nonresidential investment is due to the significant decline in interest rates. (In fact, interest rates are down more than in the no tax increase case, although that is due to the fact that real GNP increased in that case while it declined in this case). Interest rates would decline more in the case of a personal tax increase than in the case of a business tax increase since only a small percentage of each dollar raised through a personal tax increase would have been saved. Thus, the deficit is reduced by a much greater percentage than is domestic savings, so that the deficit as a percent of domestic savings falls sharply.

Conclusion

It is generally recognized that deficit reduction is important for the long-term health of the economy. However, the way in which the deficit is reduced is equally important. Deficit reduction through slower growth of federal spending is definitely the best course for the economy but appears to be politically unattainable. Therefore, if tax increases are required as a second best alternative, we should choose that form of tax increase that would do the least damage to the nation's long-run growth potential.

Table 2

Macroeconomic Impacts of the Gramm-Rudman-Hollings Proposal
with a Business Tax Increase and Accommodative Monetary Policy[1/]
(percent change from baseline)

	1986	1987	1988	1989	1990	1991
Real GNP	0.2	0.3	-0.2	-1.1	-2.2	-3.2
Inflation (Percentage Points)	0.0	0.2	0.4	0.6	0.7	0.8
Employment (Millions of Jobs)	0.0	0.1	0.0	-0.2	-0.4	-0.5
Mortgage Rate (Percentage Points)	-0.4	-0.9	-1.2	-1.4	-1.5	-1.5
Housing Starts						
(Thousand of Units)	69.7	153.0	177.7	155.2	100.0	28.3
% Change	3.7	7.7	9.4	8.4	5.4	1.5
Single Family	42.5	86.6	93.6	71.0	31.2	-14.0
% Change	3.7	7.0	7.8	6.0	2.6	-1.1
Multi-Family	27.2	66.3	84.2	84.3	68.8	42.2
% Change	3.7	8.9	12.2	12.8	10.5	6.5
Nonresidential Investment						
Equipment	0.7	-0.2	-3.9	-8.3	-12.4	-15.3
Structures	0.5	0.8	-0.2	-1.6	-4.0	-6.5

Source: NATIONAL ASSOCIATION OF REALTORS®

[1/] Note: For this simulation, the investment tax credits for equipment and structures were both cut in half and the average recovery periods for equipment and structures were lengthened to 9.2 and 30.0 years, respectively. Federal spending was cut using the guidelines set out in the Gramm-Rudman-Hollings law. In 1986, the increase in business tax receipts contributes 42 percent of the deficit reduction necessary to reach the GRH target, while cuts in defense and nondefense spending contribute 31 percent and 27 percent, respectively. By 1991, these figures are 29 percent attributable to business tax increases, 39 percent from defense spending cuts and 32 percent from nondefense spending cuts.

Table 3

Macroeconomic Impacts of the Gramm-Rudman-Hollings Proposal
with a 10% Personal Tax Rate Increase and Accommodative Monetary Policy[1/]
(percent change from baseline)

	1986	1987	1988	1989	1990	1991
Real GNP	-0.3	-0.4	-0.5	-0.6	-0.8	-1.0
Inflation (Percentage Points)	0.0	0.0	-0.1	-0.2	-0.3	-0.3
Employment (Millions of Jobs)	-0.2	-0.3	-0.3	-0.2	-0.2	-0.3
Mortgage Rate (Percentage Points)	-0.5	-1.1	-1.6	-2.0	-2.3	-2.5
Housing Starts (Thousand of Units)	59.9	122.5	167.5	181.8	170.1	140.2
% Change	3.2	6.2	8.8	9.8	9.1	7.5
Single Family	40.9	70.5	89.7	88.9	73.9	51.7
% Change	3.5	5.7	7.4	7.5	6.1	4.2
Multi-Family	19.0	52.0	77.8	92.9	96.2	88.5
% Change	2.6	7.0	11.3	14.1	14.7	13.5
Nonresidential Investment						
Equipment	-0.2	0.3	1.6	3.1	4.6	5.5
Structures	-0.2	0.2	1.2	2.7	4.7	6.8

Source: NATIONAL ASSOCIATION OF REALTORS®

1/Note: For this simulation a personal tax increase was imposed by raising the average federal personal tax rate 10 percent per year beginning in 1986 and continuing through 1991. Federal spending was cut using the guidelines set out in the Gramm-Rudman-Hollings law. Beginning in 1986, the increase in personal tax receipts contributes 76 percent of the deficit reduction necessary to reach the GRH target, while cuts in defense spending and nondefense spending each contribute 12 percent. By 1991, these figures are 14 percent attributable to personal tax increases, and defense and nondefense spending each contributing 43 percent.